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September 9, 2002

Mary Cottrell
Secretary
Department of Telecommunications and Energy
One South Station – 2nd Floor
Boston, MA 02110

Re: Joint reply comments in Docket DTE 02-40

Dear Secretary Cottrell,

Please find enclosed one original and ten copies of the joint reply comments of Centrica North America and TXU Energy Retail Company LP in Docket DTE 02-40. An electronic copy has been sent via e-mail to dte.efiling@state.ma.us.

Should you have any questions or comments regarding this filing, please do not hesitate to contact me.

Best regards,

Kevin Wellenius

Joint reply comments of

Centrica North America and
TXU Energy Retail Company LP

in docket DTE 02-40

September 9, 2002

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1 Introduction

The breadth and volume of initial comments received by the Department in this docket indicate the range of opinions of what default service should be and how it should be provided. Several parties, including Centrica and TXU, provided substantial detail not only on the broad aims of default service reform, but on specific mechanisms as well.

Numerous implementation issues will doubtless need to be finalized, and we do not underestimate their importance. In the instant proceeding, however, we feel that broader concepts and decisions are at issue. We offer these reply comments to assist the Department in gauging the ability of its reforms to attract the new entrants necessary to support vigorous retail competition.

2 Summary of retailing principles

The spectrum of initial comments filed by various parties illustrates diverse views on the role of default service, the role of retailers in a market where such default service exists, and the scope for improvements in retailing functions. Progress in spurring retail competition in Massachusetts must begin with a clear articulation by the Department of its vision of how the market will ultimately work.

Centrica and TXU believe efforts at improving retail competition must be guided by the following principles:

- **Customer benefits are best achieved through competition** – The Electric Restructuring Act clearly stated the Legislature's belief that customers will be best served "... by moving from the regulatory framework existent on July 1, 1997…to a framework under which competitive producers will supply electric power and customers will gain the right to choose their electric power supplier."[1] When providers compete for customers, they have the incentive to continuously search for ways to reduce costs and improve service; a result that is difficult to achieve through regulation.

- **Customer relationships are the core of a retail business –** Proposals that seek to involve retailers in any way must recognize that customer contact and customer service is what retailers like Centrica and TXU desire most.[2] Retailer interest will follow opportunities for developing customer relationships, while proposals that do not offer such opportunities will receive limited attention.

- **Default service will ultimately serve only a backstop role** – Each customer has its own unique set of preferences. Some will be highly price-sensitive, while others will favor stable rates, and yet others will desire premium customer service above all else. Unless the Department intends to design several dozen different mandatory default service options, the logical conclusion is that most customers will find the optimum retail plan in the competitive market, not in default service. The appropriate role of default service, after an initial transition, should be to serve as a temporary backstop measure for the brief period of time required for a customer to sign up with a competitive retailer.

- **Default service pricing must be consistent with retail competition** – At a bare minimum, default service should reflect the full cost of providing that service. Current provision of default service by distribution utilities is made possible only by the recovery of certain costs through delivery charges. Delivery charges must be unbundled to establish separate rates for distribution "wires" services and retail-related services, the latter to be charged only to customers actually taking retail service from the utility.

- **Incumbency advantages resulting from distribution companies selling electricity at retail are likely to be strong, and threaten the development of retail competition** – The historical role of distribution utilities as monopoly electricity providers threatens to hamper the ability of retailers to attract customers, even if they offer better prices and service. By providing default service through non-utility retailers, many of these advantages are dismantled, allowing for unbiased selection among retail options.[3]

The two final principles form the basis of the actions we urge the Department to begin now: unbundling of retail costs from delivery charges, and developing a mechanism by which default service is provided by Alternate Default Service Providers rather than existing distribution

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1 Electric Restructuring Act, G.L. c. 164, §1(c).

2 "[t]he essence of retail service is customer contact." Initial comments of TXU Energy Retail Company LP ("TXU"), at 13.

3 Limiting incumbency advantage would not necessarily preclude participation in the retail market of a distribution company's independent retail affiliate, especially if there are limits on the ability of the affiliate to capitalize on its relationship to the incumbent utility.

companies. These two actions are required to address distortions that currently impair retail entry, while providing no benefit to default customers.

3 Default service must be properly priced

At a minimum, the Department should ensure that any future default service plans price this service properly. Many parties have filed comments supporting the broad concept that the price of default service should not be below the cost of providing it.[4] These costs go beyond wholesale energy costs alone. Additional elements of providing default service include:

- administrative costs;
- volume risk associated with customer switching, to the extent the default service provider does not shift this risk in its energy contracts;
- bad debt costs; and
- billing, collection and customer service costs.

None of these costs are currently reflected in the price of default service, but instead are recovered through delivery charges. Any customer switching away from default service will therefore continue to pay for some retail-related costs, even though they no longer take retail service from the distribution utility. Since a rational customer will only be willing to switch to competitive retail service if the competitive retail price is less than the default service price, any artificial reduction to default service prices will artificially deter customer switching and impair retail competition.

To address this distortion, retail-related costs currently embedded in delivery charges must be shifted to default service charges. The total cost to customers taking default service will not change; only the allocation between default service charges and delivery charges will be affected. This ultimately will require an unbundling rate proceeding, as noted by several parties in their comments. At least one party, however, has suggested the use of a credit to delivery charges coupled with a surcharge to default service prices as an interim measure to improve price signals while avoiding double-charging consumers. [5]

Several parties also commented on the manner in which wholesale energy should be procured. Procurement refinements are desired both to improve the price signal to default service customers as well as to ensure wholesale energy costs are consistent with low and stable prices to consumers. While several parties' observations are timely and appropriate, we urge the Department to heed the comments of ISO-NE regarding the close connection between retail and

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[4] See, for example, Initial comments of Massachusetts Attorney General ("AG"), at 5; and Initial comments of Duke Energy Trading and Marketing, LLC ("Duke"). at 3-4.

[5] DOER, at 6 and 31.

wholesale markets.[6] Any procurement prescription has the potential to distort wholesale markets by shifting forward contract activity to only the specific types of contracts that form part of the prescription. Given the significant volume of customers that will be on default service after standard offer expires, this distortion could encompass a major part of the entire wholesale volume in New England. The use of Alternate Default Service Providers, described in the following section, allows the Department to regulate prices but gives retailers the flexibility to procure wholesale energy in whatever manner they see deem most appropriate.

4 Providing default service through independent retailers

Retailers in Massachusetts face obstacles beyond the distorted default service prices addressed above. In addition, they face entry into a market dominated by long-standing incumbent distribution companies. This poses several challenges:

- Successful entry must be predicated on achieving at least some minimum scale. If customers can only be acquired through gradual switching away from default service, there will be significant uncertainty regarding a retailer's ability to achieve a viable size of operation.

- Default customers will not only choose between their current service plan and a competing retailer's offering, but will also be choosing between a utility with a long-standing reputation and a relative newcomer. This will tend to make customers reluctant to switch, even if a retailer offers better prices and can provide superior service.

- Even in the case of consumers who select service options based only on price, the onus of offering a discount to default prices falls solely on new entrants. In other words, customer latency favors a single company – the incumbent utility – at the expense of all others.

Each of these obstacles to retailer entry stem from a single source: the dominant position of incumbent distribution utilities. This problem will persist if the distribution utility is the sole default service provider in a service territory. While these challenges may not prove insurmountable, at the very least they will slow the pace at which retail competition develops.

We therefore urge the Department to allow provision of default service through non-utility retailers, termed Alternate Default Service Providers. All the parameters of default service – price, term, and customer service standards – will be subject to Department approval, and hence customers will continue to benefit from the protections offered by this regulated option. By having default service provided by Alternate Default Service Providers, however, the

6 "Because retail and wholesale electricity markets are intertwined, how wholesale electric market design may impact, and may be impacted by, retail electric market design is relevant to this investigation." Initial comments of ISO New England Inc. ("ISO-NE") at 1.

Department will begin the critical process of recasting the roles of distribution companies and retailers. The importance of this change in customer perceptions was clearly articulated by the Division of Energy Resources (DOER):

> The DOER recommends that the Department modify the existing Default Service structure to provide reinforcement for the necessary shift in customer focus concerning the price and terms of their power supply from distribution companies to competitive suppliers. ... These steps should be taken to ensure that mass-market consumers will be prepared to search for and evaluate competitive options that may become available.[7]

Under an Alternate Default Service Provider mechanism, competitive retailers will no longer face the burden of convincing default customers to leave the well-known utility, since default service would itself be provided by a non-utility firm. Customer inertia will be both an obstacle and a benefit to retailers, and will not indiscriminately favor one firm over another.

The arrangements by which one or more Alternate Default Service Providers are selected to provide default service in a given service area will involve a substantial number of customer accounts. This immediate acquisition provides at least an initial level of certainty regarding the number of customers to be served and the energy they are likely to consume.

Several parties, including Centrica and TXU, have suggested mechanisms by which default service customers could be transferred to competitive retailers acting as Alternate Default Service Providers. We encourage the Department to consider these options in more detail in a further proceeding. The key component of any such plan, however, should be the distribution company's full exit from the retail commodity business. In any vision of full retail competition, distribution companies are left to provide the essential network services of operating, maintaining, and upgrading the distribution infrastructure. The use of Alternate Default Service Providers implements this important feature of the retail competition landscape.

5 Evaluation of selected proposals

Several of the proposals received by the Department in this proceeding embrace some, but not all, of the essential principles presented in Section 2. The proposals of Mass Electric and NStar come up short in terms of creating a retail market in which Centrica and TXU would be interested, primarily because their plans would leave distribution companies in control of retail customer relationships for the foreseeable future. The DOER proposal shows some promise as an interim solution, which the Department could implement while it conducts a proceeding to unbundle retail costs from delivery charges, and develops a mechanism by which default service is provided by Alternate Default Service Providers rather than existing distribution companies. Figure 1 summarizes the aspects of each proposal that relate to our key principles.

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7 Initial comments of the Commonwealth of Massachusetts Division of Energy Resources (“DOER”), at 35.

Figure 1. Evaluation of selected proposals

	Default Service pricing	Unbundling of delivery charges	Customer relationship for retailers
DOER	Includes admin. and bad debt costs, plus all other avoidable costs.	Yes. Also propose interim surcharge/credit to shift some costs.	Limited to operating toll-free information number.
Mass Electric / Nantucket Electric	Based on highest winning bid in auction. Transfers bad debt to winner, so cost should be reflected in bid.	Not applicable, as all customer account services to be provided by utility.	No direct customer relationship.
NSTAR	Add admin. and bad debt costs.	No specific comments.	No direct customer relationship.

All three proposals would improve on current default service pricing through the inclusion of bad debt and administrative costs, though only DOER explicitly supports the essential review of delivery charges to remove retailing-related costs from them.

Under any of these three proposals, the only way for a retailer to actually develop customer relationships would be to attract customers to competitive retail service. Without the critical unbundling of delivery charges - which only DOER appears to support - competitive retail service will continue to appear artificially unattractive due to default pricing deficiencies and pervasive incumbent advantage.

The procurement and pricing improvements supported by these three proposals must be augmented by a commitment to delivery charge unbundling to eliminate pricing distortions. The challenge of obtaining a minimum number of customers as well as overcoming strong incumbency problems could be addressed by moving to an Alternate Default Service Provider mechanism.

6 Conclusions

The core of a retail business is the development and management of customer relationships. Electricity retailing is not primarily about managing wholesale energy risk. To be sure, energy trading is an important aspect of the business, but without the customer relationships, we would simply be energy traders, not retailers.

As businesses whose focus is customer relationships, our interest in any market is directly proportional to the scope for developing such relationships. Default service arrangements in which the role of a retailer is limited to that of taking wholesale energy risk or, at best, having our logo reproduced on a utility bill will hold little appeal to us. Conversely, a mechanism that preserves opportunities for attracting customers through appropriate default service pricing, and that works directly to dismantle the structural impediments that accompany a history of regulated monopoly service, will support a market in which we will take significant interest and an active role.

Several parties expressed the concern that it is not the role of the Department to create rules or approve rates whose only purpose is to support the entry of new retail firms. We could not agree more. All proposals must pass the same ultimate test: do they help ensure that consumers receive the best possible value in electricity service over the long term? Centrica and TXU believe that customer interests are best served when they have a choice among service providers; that operational efficiencies are maximized when these competing providers have a pervasive and full-time incentive to find ways to increase customer value; and that Massachusetts can repeat the success of retail competition seen in the UK, where price controls were deemed no longer necessary just three years after all customers were given retail choice.

Respectfully submitted,

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